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SENSITIVE

TREASURY FOR INTERNATIONAL AFFAIRS - CPLANTIER AND ASHAH
NSC FOR BRYZA AND MCKIBBEN

E.O. 12958: N/A
TAGS: EFIN TU
SUBJECT: CENTRAL BANK AND GLOBAL SELL-OFF STOP RALLY IN TURKISH FINANCIAL MARKETS

REF: A. ANKARA 1318

¶B. ANKARA 1202

This message has been coordinated with Congen Istanbul.

¶1. (SBU) Summary: A global sell-off in emerging markets, coming on the heels of a Central Bank rate cut and intervention, have caused a correction in the sustained rally in Turkish financial markets. The lira, which had hit its highest level in three years earlier this month, finally reversed course and has fallen back approximately 5% against the dollar in the last week. On March 9, the Central Bank not only cut interest rates by one percent but also intervened in the foreign exchange market, buying $2.3 billion of foreign exchange--its largest intervention since the 2001 financial crisis. These two actions, combined with favorable inflation indicators, suggest the Central Bank--like other observers--is beginning to be more worried about the outsized inflows of portfolio investment artificially inflating the value of the lira, than it is about inflation. This week's emerging market sell-off hit Turkey's currency and eurobonds slightly harder than other emerging markets. End Summary.

Emerging Market Sell-off Hits Turkey:

¶2. (SBU) A broad sell-off in emerging markets this week--triggered by increased yields on U.S. Treasuries and expectations of continuing increases--has reversed the long, strong rally in Turkish financial markets. Emrah Eksi of the Central Bank Markets Department estimated this week's outflows at about $700 million. The lira in particular, which hit a three-year high on March 3, and is widely considered to be seriously overvalued, finally reversed direction. Before the Central Bank intervention March 9, the lira was trading below 1.26 to the dollar. At the close of business March 17, by contrast, the lira was at 1.3238 to the dollar and 1.7722 to the Euro. Though the Central Bank action merely stopped the lira's appreciation, generating only a slight pullback in the lira later that day and on March 10, the change in global markets beginning Monday, March 14 caused the substantial depreciation of the lira this week, with the biggest declines on Monday and Wednesday.

¶3. (SBU) Though the sell-off has had a significant impact on equities--notably with a 4.58% fall in the IMKB 100 March 16--the impact on the government securities market has been far less dramatic. The interest rate on the benchmark bond closed March 17 at 16.54% only 73 basis points higher than the close on the day of the Bank's rate cut, which helped bring down all interest rates on all types of interest rates by reducing bank funding costs. In addition to the help from the rate cut, the impact on domestic bond prices caused by the reversal of sentiment on emerging market debt seems to have been mitigated by the relatively tight supply of new lira-denominated issuances. In the Eurobond market, by contrast, Turkish bonds fell more than other emerging market Eurobonds. Emrah Eksi explained that the continued TL issuances by foreign banks, now up to a cumulative $4.3 billion, which he said the banks are largely hedging by buying TL bonds, may explain the mild impact of the sell-off on TL interest rates. In other words, these banks' issuances are creating demand for TL bonds, braking the fall of these bonds' prices in a correction.

¶4. (SBU) The emerging market sell-off has hit Turkey harder than other markets. Last week's Central Bank rate cut and intervention (see below) signalled that the Central Bank would try to brake the rapid rise of the lira. More recently, at the same time as global sentiment shifted, the news flow has been market-unfriendly: there have been continuing stories about problems in relations with both the EU and the US, both viewed as key external anchors by financial markets. Finally, on the IMF program, not only has there been no progress, but there are signs of new problems

and delays on some of the IMF conditions that had been considered relatively easy to do: the tax administration reform law and the banking law. The tax administration reform law was sent back to a parliamentary sub-committee for further work (and further delay). The provisions of the banking law relating to the deposit insurance fund (the SDIF) having flexibility to temporarily keep a bank running after intervening, rather than always having to liquidate the bank, remains the principal dispute between the bank regulatory agency (BRSA) and the Treasury. According to the press reports, this, too, will now have to be decided by Prime Minister Erdogan.

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Central Bank Rate Cut at the High End of Expectations:
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¶5. (SBU) The broader emerging market sell-off this week comes on the heels of decisive Central Bank actions last week. At the market opening March 9, following the monthly meeting of the Monetary Policy Committee the evening before, the Central Bank announced a one percent cut in both its lending and borrowing rates. Analysts had been predicting a cut of between 50 and 100 basis points with the market consensus around 80 basis points. In making their predictions, some analysts had thought the Central Bank would keep the cut small in order to maintain pressure on the GOT to make more rapid progress in concluding a Letter of Intent with the IMF.

¶6. (SBU) As previously reported, Central Bank Governor Serdengecti was quite concerned about the lack of movement on concluding a Letter of Intent with the IMF, and predicted the Monetary Policy Committee might publicly refer to this problem. He also had told us he could be cutting interest rates more quickly if there were an IMF program in place. In the event, the Monetary Policy Committee's statement accompanying the March 9 rate cut never referred to the IMF by name. It did, however, refer to the need to structural reforms and fiscal discipline (i.e. the IMF program) in an apparent attempt to keep the pressure on the GOT.

Followed by Big FX Intervention:

¶7. (SBU) Markets had been expecting a Central Bank intervention in the foreign exchange market, given the continued appreciation of the lira, driven by strong inflows of portfolio investment since the beginning of the year. The Central Bank has a track record of intervening to support the lira, but always at a level lower than the previous intervention, and always insisting it is only intervening because of "excessive volatility" and is committed to the floating exchange rate regime. What has become increasingly clear to analysts is that what the Central Bank means is that it will not allow the lira to appreciate too quickly, particularly when the appreciation is driven by short-term portfolio flows.

¶8. (SBU) Shortly after the rate cut announcement, later in the morning on March 9, the Central Bank began intervening, buying foreign exchange. In the end, the Central Bank bought a whopping $2.3 billion in foreign exchange on March 9, in addition to the $45 million it has been buying every day since mid-December through foreign exchange purchase auctions. By contrast, the Bank's last intervention, in late January, was for $1.3 billion.

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Central Bank Actions Suggest a Shift in the Balance of Risks:
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¶9. (SBU) The higher-than-expected rate cut--despite the absence of progress with the IMF--combined with the huge intervention suggests a shift in the Central Bank's judgment of the balance of risks. By continuing to aggressively cut rates--January and December rate cuts were also higher than expected--the Bank seems to be indicating it is less and less concerned about inflationary pressures. Two recent data releases would appear to justify this lessened concern about meeting the 8% inflation target for 2005. February inflation, coming in below analysts' expectations at 0.02% for CPI and 0.11 for PPI, were powerful indicators that the Bank's disinflation policies are working. When the February numbers were announced, there were even articles discussing the possibility of a looming deflation--unheard of in Turkey.

¶10. (SBU) Instead of worrrying overmuch about inflation, the Bank seems to have shifted to worrying more about foreign portfolio investment inflows artificially inflating the lira and exacerbating imbalances in the balance of payments. With the 2004 current account deficit at the high end of expectations, and no sign yet that it will abate in 2005, the Bank has reason to worry. As noted in ref A, in January

alone, the portfolio investment inflows were $4 billion, equivalent to 43% of the full-year 2004 inflows.

11 (SBU) The correction is healthy: it reduced, albeit slightly, the overvaluation of the lira, and may have dampened portfolio investors' irrational exuberance. That it did so without causing interest rates to spike is particularly fortuitous. If the portfolio inflows resume--with some analysts saying the correction allows investors to re-enter the market--the shift in the balance of risks away from inflation to the current account and exchange rate is likely to continue.

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